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INTERNATIONAL AND DOMESTIC MONETARY REFORM

In recent weeks, there has been much discussion regarding the possibility of using a market basket of commodities, including gold, to guide the monetary policies of the major industrial nations. U.S. Treasury Secretary James Baker, French Finance Minister Edouard Balladur, members of the Federal Reserve Board, and others have spoken approvingly of the concept. At the moment, the driving force behind the proposal is not a great fear of renewed worldwide inflation, but the concern over wildly fluctuating exchange rates. Wide swings in exchange rates diminish worldwide economic growth since they increase the risk of investment anywhere in the world. This, in turn, leads to lower levels of investment and productivity growth.

As a long time advocate of using internationally traded commodities as a guide for monetary policy, I am, of course, pleased with the recent interest in the approach. However, I urge policymakers to proceed with caution since much empirical work remains to be done in this area before a commodity basket can become a useful policy tool. The fundamental problem with any commodity basket is that commodity prices lag changes in money growth rates. Hence, great care must be taken to design a basket which minimizes the lag.

In the early spring of 1984, Ronald Utt and I co-authored a paper entitled, *Monetary Reform: A Proposal for Bringing Price and Quantity Rules Together*, a condensed version, of which is reprinted following this. The paper described how a basket of traded commodities could serve as a useful guide for monetary policy. We did not explicitly note the benefits for exchange rate stability if the major industrial countries would adopt approximately the same basket of internationally traded commodities for their respective price rules. We also did not note the difficulties of imposing such a rule on only one economy without similar rules in the other major countries. Finally, we did not fully explain that price levels can be held constant at various levels of economic activity, and that the goal of economic policymakers ought to be price stability at a high level of economic growth. In fact, the major reason to oppose high rates of inflation or deflation is because price instability confuses the information business people need to make rational economic decisions. This causes economies to perform at lower real levels than they otherwise would. If policymakers attempt to implement the following proposal, they must always remain cognizant of the fact that their fundamental long run goal should be to increase real per capita incomes as rapidly as possible.

Richard W. Rahn

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MONETARY REFORM:
A PROPOSAL FOR BRINGING PRICE AND QUANTITY RULES TOGETHER

by
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(March 1984)

As has happened so frequently over the past several decades, monetary policy and the behavior of the Federal Reserve are once again at the center of debate as our policymakers consider the prospects for perpetuating a sustained recovery with stable prices.

Critics of the Federal Reserve fall into two main groups. In the first are advocates of discretionary policy who simply want a different policy from that now being pursued. They say that all would be well if only the right people -- themselves -- were in charge. The second group includes all those who distrust unconstrained Federal Reserve power. They are not interested in seizing monetary powers themselves, for they know that in our vigorous democratic system it is impossible to guarantee that the "right" people will always be in charge. They understand that the substitution of the rule of law for the rule of officials is the essence of democratic reform. This second group has grown enormously over the last fifteen years as the failures of discretionary economic management have accumulated. A much deeper appreciation of the constitutional role of the gold standard over our history has emerged as experience with unbridled discretion has accumulated. But this second group, the constitutionalists, is badly split over what rule should replace discretion. Arguments over the rule -- whether it should be a price rule or quantity of money rule -- have prevented any rule from replacing a monetary policy guided by no rule.

The failure to resolve this debate among those who harbor a deep suspicion of the Fed's ability to fulfill successfully its chief responsibilities under present institutional arrangements is an inexcusable misfortune. The failure represents missed opportunities whose costs can be measured in the debasement of our currency, lost jobs, capricious shifts of wealth between sectors of our society and lower incomes for our citizens. This persistent failure to agree on a solution by both price rule and quantity rule advocates is surprising inasmuch as the opposing groups have so much in common. Both sides view the Fed's central responsibility as one of maintaining stable prices, and both agree that sustained inflation is a monetary phenomenon. But beyond these axioms, the agreement collapses as opposing groups disagree on the mechanics of how one implements the objective of price stability.

In an effort to resolve this debate, we have developed a proposal that we believe could accommodate both factions and substantially improve the course of future monetary policy. Combining both elements of a price rule and a quantity rule, we believe that this proposal would be superior to either rule taken individually and certainly superior to a continuation of a policy wholly dependent upon the discretion of the Fed -- a policy guided by no rule. In this article, we first define the monetary policy problem and then discuss in detail how our proposal would address that problem and the apparently intractable debate that now consumes the groups that ought to be united in seeking a solution.

A Problem Emerges, Again

The fundamental problem of our monetary arrangements -- the absence of any rule or standard -- becomes painfully clear from time to time, and then seems to slip into the background.

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This is not the place to recount the history of these episodes that bring our fundamental monetary problem into focus -- although doing so would demonstrate that today's situation is not unusual -- but it is helpful to discuss the present episode in some detail in order to understand the value of the proposed rule.

Following a period of relative calm, there has emerged in recent months both grave concern and general dissatisfaction with the recent course of monetary policy. There are many sources of concern. They range from the absence of a discernible policy direction to recent statements by members of the Board of Governors implying that an accommodative monetary policy will be held hostage to meaningful congressional action on the budget deficit, which action might well include counter-productive tax increases. Heightening these concerns is the upward drift in interest rates, a depreciating dollar, increases in commodity prices, and a general sense of unease that is spreading through financial markets.

What is apparent in reviewing both the Fed's performance and the deliberations of the Federal Open Market Committee is that the Fed is acting in a highly discretionary manner, attempting to manage the course of the U.S. economy according to its own judgment of where the economy is now and where it will be in the next quarter or two. In short, there appears to be little or no recognition that sustained inflation is always and everywhere a monetary phenomenon and that trends in the real economy, when divorced from changes in money growth, have little bearing on past, present and future inflation.

This approach to policy leaves the Fed rudderless. It is impossible for the Fed itself to predict its own future actions. Because it cannot predict its own actions, and will not commit itself, its public stance is one of obfuscation. It reports "ranges" -- the word "target" has disappeared -- for four different monetary and credit variables. Those ranges are subject to revision at any time. Alleged difficulties in defining, measuring, and controlling money are used to "explain" why money growth surges or sags. Because the Fed is rudderless, the market has absolutely no way to predict the future course of money growth, the price level, interest rates, or the level of economic activity.

Desperately Needed: A Solution

Many had thought that the problem of determining the proper course for monetary policy had been resolved in October, 1979, when the Fed appeared serious about acheiving a target growth rate for M_1 that was consistent with a gradual deceleration in inflation.

In changing its operating procedures in 1979, the Fed implied that it would seek more stable growth in the monetary aggregates and would eschew interest rate targets and fine tuning of the economy. In practice, however, this new policy, as implemented by the Fed, led to exceptionally erratic month-to-month and quarter-to-quarter changes in M_1 that we and many others believe was a key contributor to the depth and duration of the recession and high real interest rates. The October, 1979, policies were described by many as "monetarist", but that designation is wrong. Money growth became less rather than more stable and predictable.

Despite the fact that the restraint on monetary growth contributed to dramatic declines in both inflation and interest rates in 1981-1982, monetarism became associated with recessionary policies, and public support for monetary targeting evaporated over concern for high unemployment and negative real growth. The Fed was only too happy to comply with public and congressional concerns by abandoning any attempt to hit monetary growth targets. It quickly reverted to past policies of attempting to fine tune the economy by targeting the Fed funds rate.

In recognition of the damage that could follow from a Federal Reserve operating in an environment devoid of any rules and guidance, we propose a new set of procedures that are founded in two principal axioms that most economists accept:

1) The chief responsibility of the Federal Reserve Board is the maintenance of price stability; and

2) Sustained inflation is largely a monetary phenomenon.

It follows, then, that the course of monetary policy should be guided by rules that relate primarily and directly to prices and that some index of sensitive prices would be ideally suited as the chief indicator to guide the Fed. But what the Fed actually controls day to day is its own portfolio. The Fed does not buy and sell commodities with sensitive prices, but government securities. Accountability under a rule requires that the rule link the price objective to the Fed's open market operations in government securities.

The recommendation that the Federal Reserve stabilize prices has been made by others in the past only to be rejected by the traditional monetarists who believed that steady money growth at a low rate would be sufficient to achieve sustained price stability. With our monetarist sympathies, we, too, felt this way, believing that the inclusion of additional policy indicators simply confused the issue, and that the attainment of the announced moderate money growth targets would be more than adequate to ensure price stability. In short, we continued to believe that the Fed would adhere to its own announced money growth targets.

In retrospect, however, this outcome did not materialize. Publicly-announced monetary targets have been in force since 1975, but the Fed has been unwilling to meet them in a consistent fashion. Monetary growth, as measured by M_1, has been highly erratic, creating uncertainty in financial markets. Indeed, the case can be made that the announced targets have had no effect whatsoever on Fed policy.

From this experience, we have come to the conclusion that firmer limits must quickly be imposed on the Fed to ensure accountability and the implementation of monetary policies consistent with certainty, stable prices and sustained economic growth. Constitutionalists must find a way of joining together to define a compromise rule. The debate over what rule is optimal should be suspended temporarily in order to construct a rule that is better than the absolute discretion that now determines monetary policy.

The basic features of a compromise rule must reflect the following considerations. First, monetarists insist that a rule must be defined, operationally, in terms of Federal Reserve control over money growth. This position reflects their views on monetary theory and, most importantly in the present context, the fact that the Fed has the technical means for controlling money growth. Under present circumstances, the only magnitude the Fed can be held strictly accountable for controlling is the M_1 definition of money or alternatively, the monetary base on bank reserves.

Second, monetarists have always been less interested in a *constant* money growth rule than in a *defined* rule. That is the point where there is ample room for quantity rule and price rule advocates to come together. To limit Federal Reserve discretion, price rule advocates must in any case define what the Fed should do, operationally, when prices are rising or falling. What is the measure of a "tighter" or "easier" policy?

Price rule advocates fear a constant money growth rule because it makes no allowance for money demand shifts. They believe that it makes no sense to hold money growth constant when the behavior of prices clearly signals inflation or deflation ahead. If prices are tending to rise because money demand is falling, then the money supply must fall to stabilize prices, and vice versa. The essence of the problem is to define a rule whereby money growth rises when there are downward pressures on prices, and falls when there are upward pressures on prices.

To implement a policy based on the price rule, an index of sensitive commodity prices, which could consist of a basket of widely traded commodities or precious metals or some combination of the two, would be designated as the chief indicator of required monetary ease or restraint. Since the prices of various commodities tend to respond with different lags to changes in the money supply, the commodities included in the basket should be limited to those whose prices respond quickly to economic circumstances. Minimal time lags are crucial to allow for the quick implementation of a change in monetary policy and to avoid the destabilizing effect of tying

money growth to prices that respond with a lag. Commodities that should be excluded from such an index are those that are extremely sensitive to political changes independent of the course of monetary policy. Energy prices, for example, are highly sensitive to political factors. Many commodities with sensitive prices are, of course, subject to volatile supply conditions, as with food. To prevent false signals due to supply disturbances, the index should include a diversified list of commodity prices, and commodities particularly subject to supply disturbances should receive less weight in the index.

With such an index established as the indicator of appropriate monetary ease or restraint, the Federal Reserve would be required to stabilize this index within some permissable target band by adjusting the rate of money growth. Should the index exceed the upper limit of the band for some specified period of time, the Fed would impose firmer limits on monetary growth until the index returned to within the target band. Likewise, should the index fall below the bottom limit of the band, the Fed would raise money growth until the index rose to within the target range. With changes in the index available on a daily basis, the Fed would have instant access to market trends and the market's reaction to its policies. The changes in money growth required of the Fed would be carefully specified so that financial markets would not be surprised or faced with additional uncertainty.

To avoid the extreme gyrations in policy, the rule would call for moderate changes in money growth on the basis of the price index signal. This could be done in one of two ways. First, the existing form of target ranges for M_1 growth could be narrowed to a range estimated to be consistent with stability in the commodity price index. This range, however, could be adjusted periodically if the range were found to be overly restrictive or accommodative. Suppose, for example, that the price index were falling while M_1 growth remained at the top of the range. This combination might suggest that the M_1 range was misspecified or that there had been a shift in the demand for money since the initial range had been established. As a result, the target range for M_1 would be adjusted upward by, say, one percentage point. Prices might then be stabilized within their target range and the new target range for M_1 would be maintained as long as prices remained stable. If the one percentage point adjustment were not sufficient, the range would be subject to further adjustment after some specified period of time, say six months.

Another alternative, suggested by Robert Genetski, would allow the Fed a "range of discretion" regarding the creation of money. His range is expressed in terms of the monetary base and would limit the Fed to making changes in the monetary base of between $0 and $1 billion on a monthly basis. That is, in any month, the monetary base could not decline nor could it rise by more than $1 billion. The range of discretion could change automatically in response to changes in the index of sensitive commodity prices. Specified percentage increases in the index would lead to a progressive lowering of the monthly range of discretion until prices were stabilized, while specified decreases in the price index would lead to progressive increases in the range of discretion. Obviously, the same mechanism could be incorporated when target growth ranges for M_1 represented the target defining the range of discretion. Genetski prefers the monetary base to M_1 because it is less likely to be subject to definitional uncertainties and is easier to control than M_1.

An obvious objection that could be made by both traditional monetarists and advocates of a formal price rule is that this proposed system, by focusing on both quantity and price, attempts the impossible. They would note, quite correctly, that the central bank can meet a price target or a quantity target, but not both. Price advocates would argue that the goal of price stability is sufficient and any attempt to focus on money as a target could lead to financial instability if the target was incorrectly specified. Similarly, monetarists would argue that steady and moderate growth in M_1 would automatically lead to stable prices.

While there is merit to both views, there are a number of good economic, political and institutional reasons for attempting to monitor and influence both price and M_1 on the basis of limited discretion. The first reason is that neither of these variables is an infallible target or indicator and any attempt to limit discretion to one or the other could lead to severe problems if the objective was misspecified or if nonmonetary influences became prominent at various points in

time. While inflation is a monetary phenomenon, many other factors also come to bear on the price of any commodity. Supply shocks, changes in exchange rates and international instability could disrupt commodity markets, send the wrong signals to the Fed and force it into a policy that may disrupt the economy. Likewise, in a regime characterized by a rule holding money growth in a narrow range, shifts in the demand for money could lead to rising or falling prices if quantity targets are adhered to with no regard whatsoever to price signals. In either case, the misspecification of targets could lead to economic problems.

Second, a single, rigid target would, ironically, still allow the Fed too much discretion. Anyone who has followed Fed behavior for the past many years recognizes that the Fed is remarkably adept at developing and successfully marketing all manner of excuses to justify its mistakes and its failure to act according to previous commitments. Moreover, there is no shortage of economists, politicians and financial market participants willing to accept these excuses and add further justifications for them. In a democratic society, any rule, regardless of how appropriate it might be, is enforceable only if it receives support from the vast majority of those who have an interest in the issue or institution being restrained. If a rule does not command wide support, then it will be flaunted at will whenever it is convenient to do so, and all sorts of good excuses to justify its violation will be developed.

One can easily envision the same sort of behavior under a price rule. Suppose, for example, that the designated price index began to rise and that the Fed took no action to reestablish stability. When confronted with evidence of rule violation, the Fed could raise any number of extenuating factors to justify its behavior. Wars in the Middle East, financial difficulties in developing countries, and technological innovations could all be used to explain short-run changes in a price index that most recognize to be potentially volatile and subject to influences beyond the monetary policies of a single nation. As in the past, the interested public would accept these excuses, at least temporarily, and Fed policy would again revert to purely discretionary standards of behavior.

The beauty of a well-defined standard relying on multiple indicators is that one would serve as a check on the other and diminish the Fed's degree of freedom to develop seemingly plausible excuses to justify the violation. But a rule, to be politically viable, must be simple enough to be understandable. A two-indicator rule, focusing on money growth and sensitive prices, probably accomplishes 95 percent of what might in principle be done with a far more complex rule. A combination price and quantity rule is sensible and understandable; a voter does not need a Ph.D. in economics to evaluate such a rule. At the same time, it would allow the Fed some minimal amount of flexibility to use its discretion in adjusting for special influences on both price and/or quantity. If, for example, the price index wandered toward the upper limit of its band, the Fed might take no action because it felt that nonmonetary factors were the cause. But if the Fed's judgment were wrong and the price index broke through its upper limit, the rule would require that money growth be slowed somewhat.

Options for periodic review and revision of target ranges are essential if we are to monitor and influence both price and quantity. No legislated rule, not even a constitutional amendment, is enacted for all time without possiblity for change. With experience, the price/quantity rule may be changed. As [illegible] the ranges encompass the likely equilibrium point and are adjusted when fundamental [illegible] occur, this policy mechanism will not force the Fed to accomplish the impossible. But if experience demonstrates that the price index should trigger either larger or smaller changes in money growth, so be it. The fact that a rule might have to be changed is never an argument for having no rule at all. With the proposed combination rule, the Fed would be held to a responsible and workable standard of accountability that is superior to the present system of unchecked discretion.

Proponents of price and quantity rules will continue to debate the relative merits of these rules. The introduction of a combination rule can begin an evolutionary process that, through experience, may lead to adjustments in the combination rule toward either a price rule or a quantity rule. But unless rule advocates can agree on a combination rule, the debate will remain an academic one.

The End Result

It is our belief that the implementation of a set of guidelines modeled on the above proposal would lead to a monetary policy far superior to that of the last two decades. As we look at the performance of the economy during the postwar era, we cannot help but conclude that the Federal Reserve played an important role in exacerbating the cyclical tendencies inherent in the U.S. economy. This pattern has been especially clear since 1965. By stimulating recoveries well beyond the point where inflation becomes a problem, the Fed has then been forced to adopt policies of severe stringency to reduce the inflation that it largely induced. Left to its own judgment, the Fed will persist in the roller coaster policy of ease and restraint and the U.S. and world economies will suffer accordingly.

With our proposal there would be little likelihood of these periodic bouts of austerity occuring inasmuch as adherence to the proposed guidelines would ensure that inflation never got out of control. Essential to eliminating the "stop" phase of the cycle is eliminating the "go" phase. Monetary restraint must be applied gradually when inflation problems first emerge and are easier to cure. The political problems that invariably arise whenever the Fed leans toward restraint, no matter how minor, would also diminish since its actions are now mandated by the rule.

Another major advantage would be the financial market's renewed sense of confidence in the Fed. With reasonably firm rules guiding Fed actions, there would be no need constantly to guess what policy the Fed is pursuing at any given time and how the Fed will react to a wide variety of economic events. Future Fed actions could be estimated with a greater degree of certainty and interest rates would decline as financial market participants realized that risk premiums were no longer required as a protection against unanticipated Fed policy changes.

All rule advocates recognize that their own favorite rules have at times provided misleading guidance. But a rule is not desirable because it is infallible; the issue is the alternative. The advocates of a price rule should decide whether the present discretionary system is better than a quantity rule, and the advocates of a quantity rule should ask the corresponding question about a price rule. By refusing to face those questions, price rule and quantity rule advocates permit discretion to win by default. The founding fathers recognized full well what government by discretion was all about. Surely price rule and quantity rule advocates can construct a combination, or compromise, monetary rule. That is what this paper is all about.